

Revenue & Cost

This Power Tip helps you stay on top of your cash flow by understanding the fixed and variable costs in your business, and the difference between marginal revenue and marginal costs.

Business
Power Tips



Fixed Costs & Variable Costs

Fixed Costs

When you operate a business, there are some costs you're going to incur no matter how many sales you make - for example, rent, insurance and loan repayments. These are your Fixed Costs.

Variable Costs

Other costs are based on the number of sales you make, like the stock and materials you use to make your product or provide your service. These are your Variable Costs.

Some costs can seem to fall in between, like staffing. A full time staff member would be a fixed cost, while casual staff can be managed like a variable cost. This can also happen with utilities. You might have a monthly connection fee, which would be a fixed cost, but how much you use would be a variable cost.

Being clear on whether costs are fixed or variable can be a big help in how you manage your business.

For example, if you're an artist, you might have a studio and pay monthly rent – that's a fixed cost. But how many brushes, paints and canvases you use each month depends on how much you paint. That's a variable cost.

Marginal Revenue & Marginal Costs

When you set a price for your product or service, it needs to cover all your fixed and variable costs, but it also needs to include an appropriate margin so your business makes a profit. However, sometimes your business may not be able to cover all your costs. Whilst this is not a sustainable position for you and your business, it can still make sense to keep trading as long as the marginal revenue from your next sales is greater than the marginal costs. This is because, whilst your business is not currently making a profit, you are still making a contribution to those fixed costs that you need to cover.

Marginal Revenue is the additional revenue from the sale of one additional product or service.

Marginal Cost is the variable cost of producing this additional product or service.

By understanding your Marginal Revenue and Marginal Cost you can know when you should keep trading and when you should stop.



Watch the full video:
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Example:

Bob's Bicycles

Bob constructs and sells bikes for \$500. This covers his \$250 of variable costs for bike parts and makes a \$100 contribution to his fixed costs for his bike shop rent, leaving Bob with a profit of \$150 from the sale of each bike.

Down the track Bob may no longer be able to sell his bikes for \$500 because of a change in the market for his business - maybe people are not too interested in buying bikes for a period or maybe a competitor is offering a sale price.

What should Bob do?

It is good for Bob to know that he can, for a short period of time, continue to sell his bikes as long as he is selling the bikes at a higher price than his variable costs of \$250. This is because each time he sells a bike above \$250 he is still making a contribution to his fixed costs.

If Bob is unable to sell his bikes for at least \$250 then he should stop trading, as he is unable to cover his variable costs of making a bike.

It is important to remember that this is not a sustainable position for Bob, as at some point the price of his bikes needs to cover all the variable costs, a share of the fixed costs based on the number of sales he would normally make, and with a margin to make a profit.

Focusing on Marginal Revenue and Marginal Cost is not a way for your business to be sustainable in the long-term, but it can help to know when to keep trading if your business is facing challenging times. It also provides an opportunity to maintain operating

momentum whilst you build and innovate your business.

This can be a complex topic, so make sure that you speak with your Business Coach so you can fully understand how this Power Tip applies to your business. It's also a good idea to check out the Introduction to Cashflow resources on the Many Rivers website.

Many Rivers has a team of business coaches that can help you establish strong cash flow management practices that are right for you and your business, so get in touch with us and ask for help.